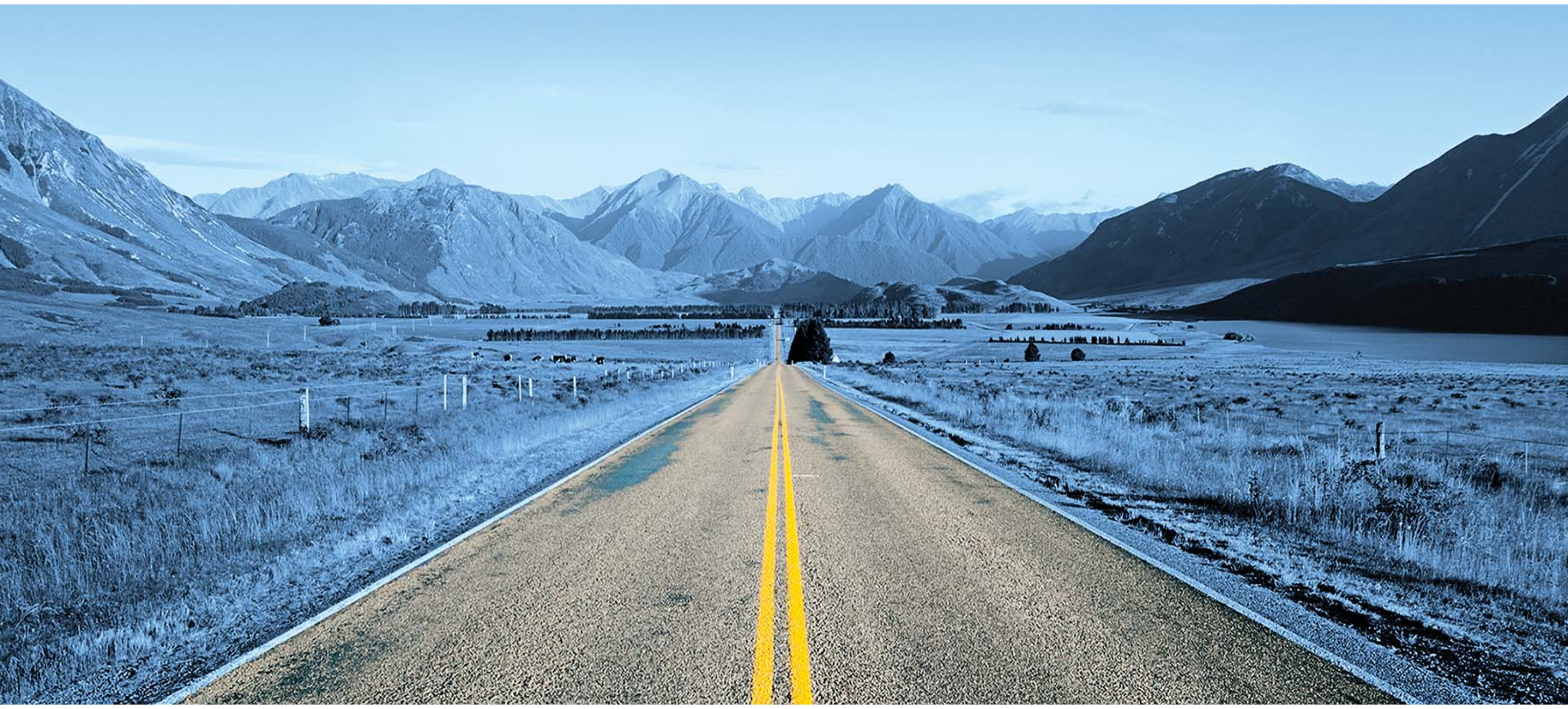
Preqin Investor Outlook: Private Equity

H2 2011

The Opinions of 100 Leading LPs on the Market

and Their Plans for the Next 12 Months



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Methodology:

Preqin, the alternative assets industry's leading source of data and intelligence, welcomes you to the H2 2011 edition of Preqin Investor Outlook: Private Equity, a unique look at investors in the asset class, their current opinions of the market and the outlook for fundraising in the year ahead.

Preqin Investor Outlook draws on the results of detailed interviews conducted with over 100 institutional investors from around the world during June 2011. The sample of LPs was selected from Preqin's Investor Intelligence database, the most comprehensive and accurate source of information on investors in private equity funds available today, and the interviews were carried out by our skilled teams of multi-lingual analysts.

Speaking directly to institutions located across the globe has enabled us not only to provide in-depth analysis of their current views and opinions, but to accompany this with comments from key investment professionals in their own words, providing readers with a unique insight into the attitudes of the leading investors in private equity.

We hope that you find the information included within this report useful and interesting and, as always, we welcome any feedback and suggestions you may have for future editions.

Contents:

Fundraising in 2011

Investors are gradually regaining confidence in the asset class and, while many are not investing at the same pace as in the years prior to the downturn, fund managers should be encouraged that the number of investors looking to make commitments is steadily improving. Preqin interviewed 100 institutional investors in private equity funds around the world in June 2011 to find out their attitudes towards the current private equity market and their plans for the remainder of 2011 and beyond.

Although the market remains challenging in 2011, there are signs that fundraising is picking up: up to the end of Q2 2011, 311 funds had closed during the year so far, having raised an aggregate $141.8bn, which represents over half the overall $265.7bn raised by funds that closed in the whole of 2010.

Our conversations with investors also suggest that the pace of new commitments is improving. Almost two-thirds (64%) of LPs we spoke to for this study made new commitments over the course of H1 2011, compared to the 54% of LPs interviewed for our study in June 2010 that made new commitments in the first half of that year.

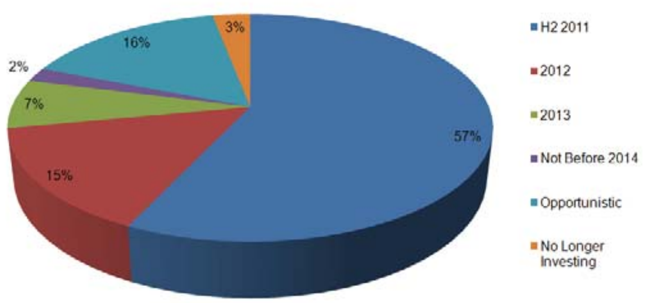
"The pace of new commitments is improving ..."

Furthermore, well over half of LPs (57%) expect to make additional new commitments before the end of the year (see Fig. 1), with a further 15% of LPs planning to make their next commitment at some point in 2012. A noteworthy 16% of investors plan to make new commitments on an opportunistic basis and therefore could invest in a new fund before the end of the year if an attractive opportunity arises.

We asked those LPs planning to make new fund commitments this year how much capital they plan to commit to new opportunities in 2011 compared to 2010. 46% of these LPs plan to commit more capital to funds this year than they did in 2010 and an additional 39% plan to commit the same amount of capital, as shown in Fig. 2.

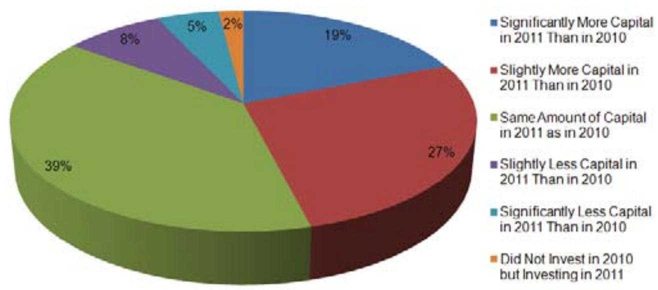
Reasons for increasing the pace of new commitments in 2011 were varied. A number of LPs commented that they have seen an increase in the number of good funds available in the market, particularly in the form of re-up opportunities. One UK-based pension fund told us: "The number and quality of funds on offer are much better than in 2010. There are more options available with the quality managers coming back to the market." Some LPs said they plan to commit more to the asset class in 2011 as they have more capital available following distributions from existing funds in their portfolio, while other investors expect to commit more in 2011 than in 2010 to build up to or maintain their targeted level of exposure to the asset class.

Fig. 1: Timeframe for Next Intended Commitments to Private Equity Funds



Source: Preqin

Fig. 2: Amount of Capital Investors Plan to Commit to Private Equity Funds in 2011 Compared to 2010



Source: Preqin

LPs' Returns Expectations

We asked the investors we interviewed about the returns they expect from their private equity portfolios, and how they feel about the performance of their existing private equity fund investments. Due to the illiquid and long-term nature of the asset class, investors maintain high returns expectations, with 70% seeking returns in excess of 400 basis points above their public market returns.

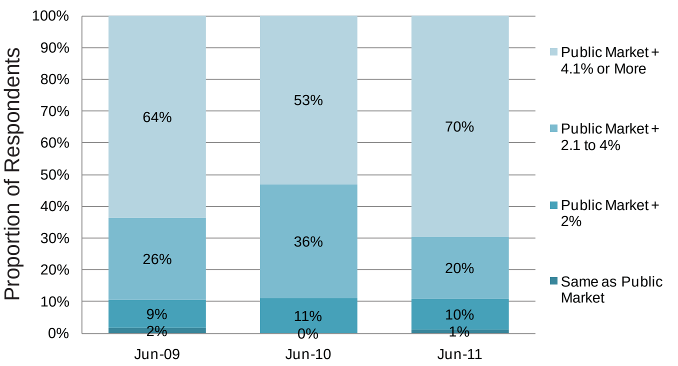
Fig. 3 shows that 90% of LPs expect their private equity portfolios to achieve returns in excess of 200 basis points above public market returns. The proportion of investors that expect their private equity investments to achieve returns in excess of 400 basis points above the public market benchmark has increased by 17 percentage points since June 2010.

"The proportion of LPs that feel dissatisfied with the overall returns from their private equity investments has steadily declined over the last two years..."

The vast majority of LPs feel that their investments in the asset class have lived up to or exceeded their expectations (see Fig. 4). The proportion of LPs that feel dissatisfied with the overall returns from their private equity investments has steadily declined over the last two years, with less than a fifth of LPs interviewed in June 2011 saying that their investments in the asset class have fallen short of their expectations.

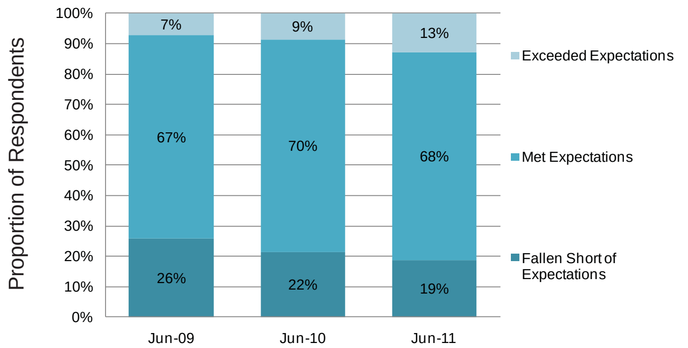
A number of investors we spoke to are conscious that private equity has not yet fully recovered from the financial crisis, and others are keen to point out they are being realistic about the returns the asset class can achieve. One European investor told us: "Before the financial crisis, our investments had exceeded expectations, but now they are only meeting them." Another LP, based in the Netherlands, commented: "We would expect our private equity returns to be between +2.1% and +4% above the public market; this is a risk-adjusted premium and we believe this return to be achievable."

Fig. 3: Investors' Returns Expectations for Their Private Equity Portfolios



Source: Preqin

Fig. 4: Proportion of Investors That Feel Their Private Equity Fund Investments Have Lived Up to Expectations



Source: Preqin

Re-Ups and New Relationships

Returning LPs are an important source of capital for GPs raising their next fund – just under two-thirds (62%) of funds that closed between 2009 and Q2 2011 secured over half of their commitments from LPs that had made commitments to their previous funds.

As Fig. 5 illustrates, 98% of investors expect to make some re-up commitments over the next 12 months. A US endowment told us: “We are being very selective at the moment and will either be re-upping with existing managers or approaching managers we particularly want to become involved with over the next 12 months.”

Building new relationships with investors is also important for many fund managers with funds on the road, particularly in the current market as investors look to streamline their portfolios.

“87% of investors will consider forming some new GP relationships...”

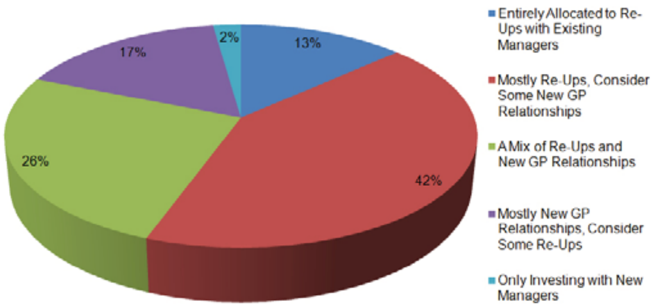
Managers seeking commitments from new LPs should be encouraged by the fact that a significant 87% of investors will consider forming some new GP relationships over the next 12 months.

Many investors are also looking to increase the number of GP relationships they maintain, as Fig. 6 shows. Over a third (34%) of investors expect to increase the number of GPs in their portfolio over the longer term, and a further 45% expect to maintain the same number of GP relationships in their portfolio in future.

A noteworthy 21% of investors expect the number of GPs they maintain in their portfolio to reduce over the longer term. One Finnish investor we spoke to commented: “We will definitely decrease the number of GPs in our portfolio by a lot – I am looking to kick out all the weak ones.”

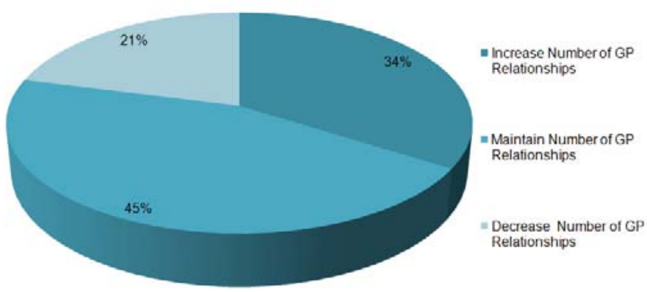
It is important to note that LPs looking to reduce the number of fund managers they invest with are still likely to consider investing with managers they have not worked with in the past. We spoke to an insurance company in Japan that expects to streamline the number of GP relationships from its current level of 35 to 25 in the longer term. Despite this, the investor expects to form some new relationships with experienced teams, explaining: “We are looking for established GPs, including spin-offs, and will not be re-upping with some fund managers.”

Fig. 5: Investors’ Intentions for Forming New GP Relationships over the Next 12 Months



Source: Preqin

Fig. 6: Likely Changes to the Number of GP Relationships Maintained by Investors in the Longer Term



Source: Preqin

First-Time Funds and First-Close Investors

In this uncertain market investors remain wary of investing in funds raised by emerging managers. Some investors are also reluctant about making commitments to funds before they have held a first close. We asked our sample of LPs about these two issues to gauge current sentiment.

Many investors remain cautious about investing in first-time funds. A substantial 49% of the LPs we interviewed will not invest in first-time funds in the next 12 months, as shown in Fig. 7. Just under 20% of investors are open to investing in funds managed by new teams, while an additional 15% would consider investing in a first-time fund in exceptional circumstances. A further 17% of LPs will invest in first-time funds if managed by spin-out teams.

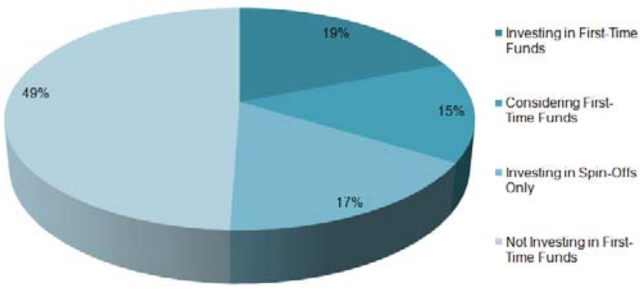
"Many investors remain cautious about investing in first-time funds..."

Only a relatively small proportion of investors interviewed by Preqin stated that they would not invest in a fund before the initial close (see Fig. 8). One New York-based asset manager commented that when making new commitments it prefers to invest before the initial close "because the best funds may only hold one close, so it's commit or lose out." Another investor, based in Sweden, also looks to be a first-close investor, commenting that there are "fantastic benefits; [investors are] penalized if [they] don't invest before first close."

A number of investors that said they would invest before the first close included the caveat that they would only be a first-close investor in funds raised by managers they have an existing relationship with, or with managers with an exceptional track record, where they feel they already have an idea of how the fund will perform.

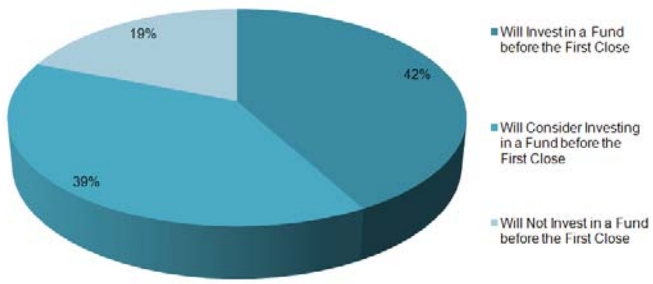
19% of LPs prefer to wait until after a fund has held a first close before making a commitment. A common reason given for investing after a fund has held a close was to ensure that there is enough interest in the fund, and to feel confident it will reach a final close. A Swedish investor noted: "Fundraising is uncertain - the fund may not come together - so [committing after the fund has held a close] is risk mitigation." A Texan investor has been deterred from committing to funds prior to the first close by a past experience: "[We] committed to a fund which then took ages and couldn't hold an initial close so had to be abandoned. Usually we will wait until near final close before committing."

Fig. 7: Proportion of Investors That Will Consider Investing in First-Time Funds in the Next 12 Months



Source: Preqin

Fig. 8: Investor Attitudes to Investing in a Fund before the Initial Close



Source: Preqin

What Can GPs Do to Stand Out?

Fundraising conditions may have shown improvement recently, but raising a fund can still pose a significant challenge for GPs given the intense competition in the market. We therefore asked investors what they feel makes a particular GP or fund stand out from the crowd.

Good Relationships

"GPs need to remember that it is a partnership and to treat LPs with respect." – A North American investor

"GPs need to have stability, be service orientated, and have no bad attitudes." – A Finnish insurance company

"We look if peers have a good relationship with GPs." – A Canadian public pension fund

Be Realistic

"GPs need to execute what they claim." – A US investment company

"Acknowledge mistakes and learn from them, consistency in strategy and proven track record." – A US asset manager

"Don't try to be good at everything, focus on the things they are really good at." – A US endowment

Demonstrate Ability to Perform in All Market Cycles

"Show how unique they are in their own strategy and make it profitable in all weathers." – A Swiss bank

"Top quartile performance over multiple fund cycles, a successful generational transition and aligned interests." – A US foundation

Strategy

"GPs need to have an executable strategy." – A Danish public pension fund

"Demonstrate good deal-flow sourcing, a clear investment strategy and a timeline for investments." – A German bank

"Keep to strategy and don't be mainstream." – A Danish insurance company

Strong Track Record

"GP needs to be well known and 'of good pedigree'." – A US foundation

"Must have a track record in the full PE investment cycle from fundraising and deal sourcing to exits." – A Malaysian public pension fund

"The track record and credibility of a manager is paramount to our investment decision. A manager must be established in their field with a solid reputation." – A UK private sector pension fund

Good Fund Terms/Transparency

"Need to be operational and hands on; if the terms are good, they will get a deal." – A Danish foundation

"GPs need to have proven ability and show transparency in fund terms." – An Irish investor

"GPs need to be more open and transparent and show they can achieve high performance." – A UK public pension fund

Key Strategies over the Next 12 Months

At the beginning of 2011 small to mid-market buyout vehicles were viewed by investors as presenting the best opportunities in the private equity fund marketplace. At the midpoint of the year, LPs are continuing to examine the market to determine where best to place their capital in the coming 12 months, and Preqin asked them for their latest views on the various private equity strategies, as well as their opinions on investments in emerging markets.

We invited investors to name which fund types they feel are presenting the best opportunities for investment in the current climate, and which fund types they expect to invest in over the next 12 months. The results are shown in Fig. 9. Respondents were not prompted to give their opinions on each fund type individually; therefore the results display the fund types at the forefront of LPs' minds.

A significant 49% of LPs feel that small to mid-market buyout funds are offering the best opportunities in the current market, and the same proportion of respondents expect to make commitments to such funds over the next 12 months. Distressed private equity and venture funds are also viewed as presenting good opportunities, with 23% and 22% of LPs naming these fund types respectively as strategies in which they are seeking to invest within the next year.

The proportion of investors with an appetite for emerging markets remains high; a considerable 78% of investors will consider investing in emerging markets. Furthermore, almost two-thirds (61%) of investors expect to increase their allocations to emerging markets in the longer term.

Investors were asked to name which regions within emerging markets they currently feel are presenting the best investment opportunities, the results of which are shown in Fig. 10.

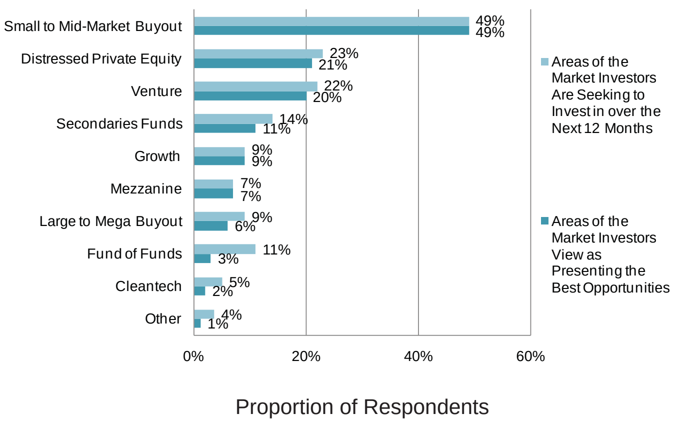
Over half (54%) of investors feel that emerging markets in Asia present good investment opportunities in the current climate; more specifically, 40% and 35% of investors named China and India respectively as being particularly attractive areas to invest at present.

"Almost two thirds (61%) of investors expect to increase their allocation to emerging markets in the longer term..."

A US-based asset manager we spoke to feels that "the best opportunities are in South America at present because of increased stability in the region." Overall, 28% of respondents identified South America as a region that presents attractive opportunities in the current climate.

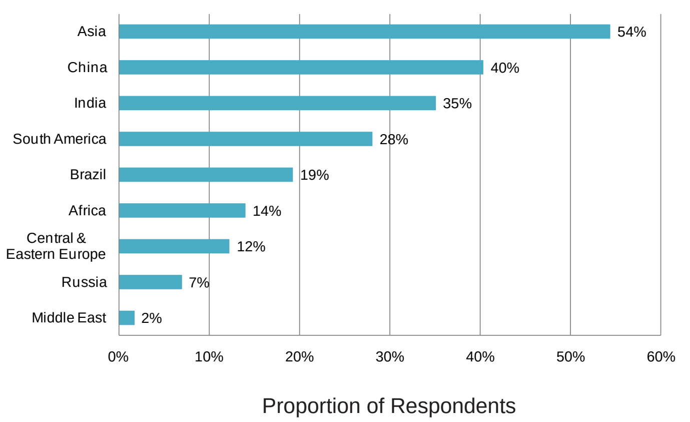
Just over 20% of investors will not invest in emerging markets. The risk associated with such investments was a common reason given for avoiding exposure to emerging regions. One Netherlands-based pension fund stated: "We feel that emerging markets are too specific for us, the risk is too high and there is too much due diligence to be completed; the governance puts us off."

Fig. 9: Investor Attitudes to Different Fund Types at Present



Source: Preqin

Fig. 10: Regions and Countries within Emerging Markets That Are Viewed as Presenting the Best Opportunities



Source: Preqin

Direct Investments, Co-Investments and Secondaries

Investing directly in companies is becoming an increasingly frequent occurrence among LPs looking for new ways to access the asset class. The secondary market has also been of significant interest to LPs recently, with many looking to purchase fund interests from existing investors in funds.

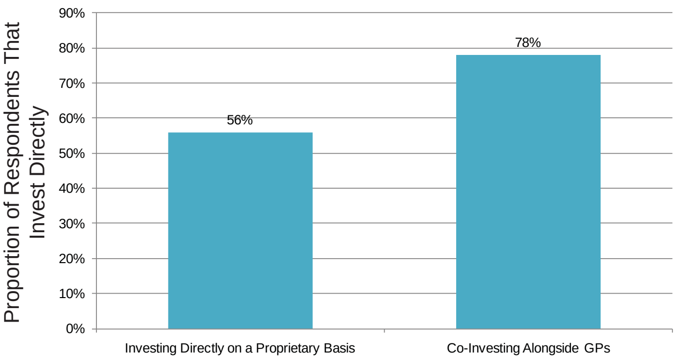
A notable 54% of the investors we spoke to in June seek to invest directly in private companies to complement their fund portfolios. Fig. 11 shows that, of the LPs that look to invest directly in private companies, 78% prefer to access such investments by co-investing alongside fund managers while 56% prefer to invest directly themselves.

"54% of the investors we spoke to in June seek to invest directly in private companies to complement their fund portfolios..."

LPs that look to make direct investments and/or co-investments were asked if they expect their levels of activity in both areas to change in 2011 compared to 2010. As Fig. 12 shows, 60% of LPs that currently co-invest expect to maintain the same level of activity in this area in 2011 as in 2010 and a further 30% expect to increase their activity. Similarly, 59% of LPs that invest directly intend to continue to do so at the same rate in 2011 as in 2010 and 28% intend to make more direct investments on a proprietary basis, indicating a considerable appetite from institutional investors for direct and co-investments.

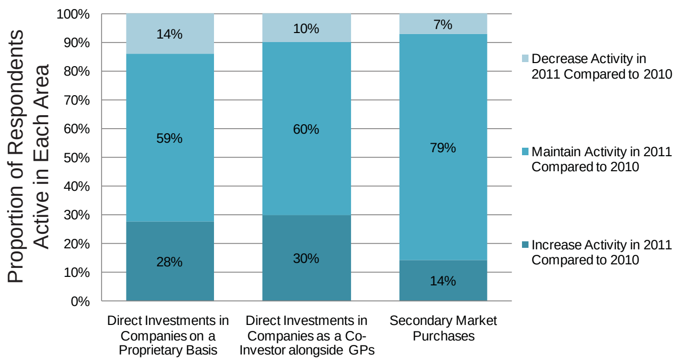
Investors were also asked about their projected level of activity in making secondary market purchases in 2011 compared to 2010. A substantial 93% of LPs with an interest in participating as buyers in secondary market transactions expect to either maintain or increase their level of secondary market activity in 2011 compared to 2010. A UK-based pension fund told us: "The secondary market currently has better opportunities than last year."

Fig. 11: LPs' Preferred Methods of Investing Directly in Private Companies



Source: Preqin

Fig. 12: Investors' Expectations of the Level of Both Direct Investment and Secondary Market Activity in 2011



Source: Preqin

Allocations and Intentions for 2011 and Beyond

There is encouraging evidence to suggest that LPs are picking up the pace of new commitments – so what can we expect for the remainder of 2011 and in the longer term?

As Fig. 13 shows, 36% of LPs are currently below their target allocations to private equity and 45% are at their targeted level of exposure to the asset class. Therefore the majority of investors are likely to continue making new commitments to private equity funds over the course of the year as they build towards or maintain their target allocations.

19% of LPs interviewed are currently over-exposed to private equity, which may deter them from making further commitments at present. One UK-based investor told us: "At the moment funds are not distributing enough capital back and we are above target. We still have a lot of drawdowns to honour and are already over-allocated, so investments at the moment will only be done opportunistically."

Conversations with LPs have indicated that they feel the quality of funds in the market at present is higher than they have seen in recent years, with a number of investors noting that good managers are coming back to market with new offerings. A Danish investor we spoke to plans to make its next commitment before the end of the year, noting: "We have the capacity, and there are the opportunities to invest."

Fig. 14 shows investors' expectations for their private equity allocations over the next 12 months and in the longer term. Three-quarters of investors expect to maintain their allocations to private equity over the next 12 months, and a further 19% of investors expect their allocations to increase over the coming year.

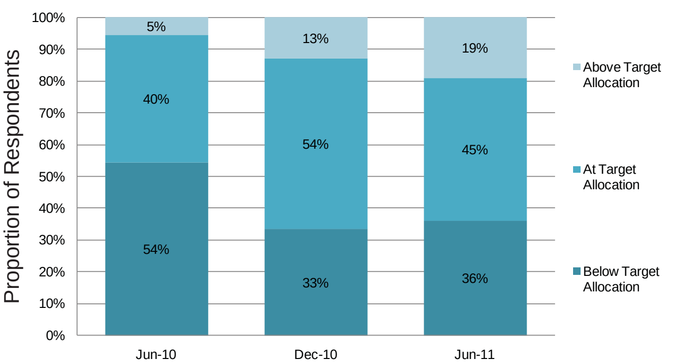
A Scandinavian insurance company told us: "It's difficult to predict our long-term allocation, but it is likely to increase and will definitely increase this year and in 2012."

"91% of investors expect to maintain or increase their allocations to private equity over the longer term..."

Some LPs we spoke to are still cautious, with concerns about a lack of available capital to invest. When asked about the number of commitments it would be making to private equity funds in the next 12 months, one Swedish pension fund told us: "We are currently at target and don't want to be over-allocated – it depends on the distributions received."

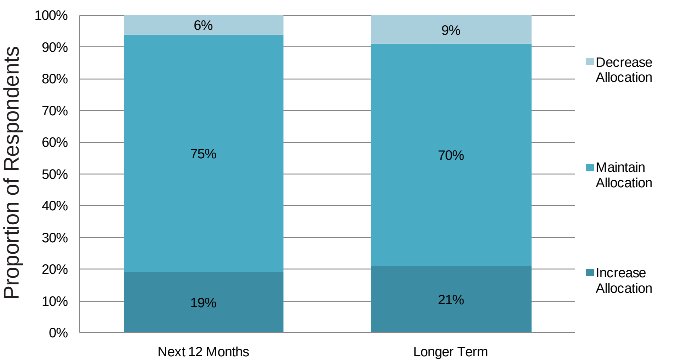
Although investors' faith in private equity may not yet be fully restored to pre-Lehman levels, an encouraging number of LPs are picking up the pace of new commitments and plan to continue to commit to new funds through 2011 and beyond. As Fig. 14 shows, a substantial 91% of investors expect to maintain or increase their allocations to private equity over the longer term, while just 9% of investors expect their allocations to the asset class to fall.

Fig. 13: Proportion of Investors At, Above, or Below Their Target Allocations to Private Equity



Source: Preqin

Fig. 14: Investors' Intentions for Their Private Equity Allocations



Source: Preqin

Preqin: A Direct Approach to Investor Intelligence

Unique, Industry-Leading LP Data

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Preqin's Investor Profiles products and services provide comprehensive and exclusive data on investors in private equity that can help you to achieve your fundraising goals. Our international teams of multi-lingual analysts speak to more than 4,000 investors in private equity each year, as well as tracking every available news and information source, to ensure that our data is as up-to-date and comprehensive as possible.

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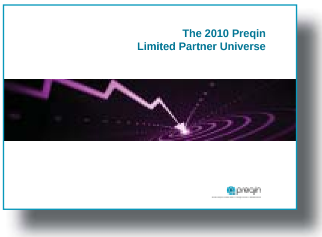
Preqin 2010 Limited Partner Universe



The Limited Partner Universe is a 600-page publication featuring a directory of over 2,700 of the most important investors in private equity worldwide, as well as detailed, vital analysis on all the latest trends affecting the private equity universe.

- Features all the most important investors in private equity, and their contact details. Investors are arranged by country and region (including US split by census region).

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